October 24, 2002

THE ECONOMIC OUTLOOK

Available economic data confirm the U.S. is in the early stages of a moderate rebound from last year's mild recession with no signs of the feared "double dip". A series of blows to the economy have had the effect of delaying at least until the first half of next year the onset of a broader based, more vigorous expansion. Uncertainties stemming from terrorist attacks, corporate governance scandals, Wall Street analysts' conflicts of interest, and, more recently, the threat of war with Iraq and its possible unintended consequences, have combined to cast a pall over business confidence. Consequently, business leaders are keeping a tight lid on both capital expenditures and the hiring of full-time employees. On the other hand, consumer spending, which accounts for about two thirds of GDP, remains steady, driven by strength in interest rate sensitive housing and autos which are at or near record high levels. In addition, stimulative fiscal and monetary policy is providing considerable support to the economy. Looking back over this year, GDP advanced 3% in the first half and, when we get figures for the third quarter, a stronger than expected 4% gain for that period is likely to be reported. While fourth quarter 2002 GDP should grow at a 3% rate, a great deal hinges on the level of holiday spending, which could be adversely affected if a war with Iraq appears imminent.

Recently released data show the economy remained mixed in the early weeks of the current quarter:

- While housing has remained strong, with single-family starts up to a 24-year high, the industrial sector has now shrunk for the second consecutive month.

- Very low rates of industrial capacity utilization are the rule of thumb early in a business recovery. This cycle is no exception. Manufacturing capacity utilization, which now stands at 74.2%, has been this low in five of the last nine post-war recessions. Importantly, capital spending began growing at a double-digit rate when utilization was in the 73-78% range in six of the last nine recessions.
- Employment remains soft with weekly jobless claims hovering near 400,000. Even if business confidence improves with the stock market, an increase in

hiring and capital spending is not likely until corporate America becomes convinced the economic expansion is durable and that the profits recovery will persist.

- Inflation remains low but deflation is not in the cards. The core CPI is up only 2.2% from a year ago, giving the Fed significant leeway to lower rates if it becomes necessary. While goods prices are deflating, they comprise only 24% of the CPI. Core services, which amount to 54% of the index, are up 3.6% during the past year showing no signs of deflating.

Corporate Profits

Better than forecast third quarter GDP growth is likely to have supported more rapid earnings advances than the financial markets have anticipated. Interestingly, of the 255 S&P 500 Companies which have to date reported their third quarter earnings, 60% have posted better results than had been forecast and only 12% have missed their estimates. Not only has the earnings recovery now begun to exceed Wall Street's diminished forecasts, but it has become more clear with the passage of time that the trough in reported year-over-year corporate operating profits occurred in the fourth quarter of 2001 as demonstrated by the figures below:

	---------Percent of Companies--------- Reporting Earnings			Year-over-Year % Change in	
	Growing	Declining	Unchanged	Operating Profits	
1Q 2001	52.7%	44.2%	3.1%	-23.2%	
2Q 2001	49.1	47.9	3.0	-39.4	
3Q 2001	46.2	52.6	1.2	-35.4	
4Q 2001	44.3	52.8	2.9	-24.4	(trough)
1Q 2002	53.5	41.7	4.8	+ 1.1	
2Q 2002	61.1	35.5	3.4	+28.0	
3Q 2002(to date)	74.3	23.0	2.7	+33.8	

Source: Merrill Lynch

The Bear Case

During the difficult market over the past 30 months, we have counseled clients to maintain commitments to equities appropriate for their situations despite many concerns which have been raised regarding the outlook. This advice has not been given without a careful weighing of the arguments and evidence supporting the negative case, and we have concluded the danger of a protracted recession is grossly overstated. Below are five of the most frequently advanced reasons for concern and our responses to each:

Bear Points	Responses
1. *Personal and Corporate balance sheets are in poor condition, which will lead to a protracted period of weak spending and sub-par growth.*	• *Consumer credit growth has already moderated and the savings rate, which had earlier been zero, has already risen to 4% of Disposable Personal Income (DPI).* • *Record refinancing activity is helping consumers service debt, which, on an adjusted basis, stands at only12.7% of DPI - - well below the levels reached in the mid 1980's when spending remained strong.* • *Most corporate debt problems are centered within the cable, energy and telecommunications areas. Corporate debt service as a percentage of cash flow is currently at 14.5%, well below peaks seen in 1975, 1982, and 1990.*
2. *There is excess capacity in many industries due to past over investment. This means that capital spending will not rebound anytime soon.*	• *In our opinion, capital spending has declined due to a fall in profitability rather than an overbuilt capital stock. Real capital spending for technology equipment and software actually rose at a 9.7% rate in the first half of this year, making it the strongest sector of the economy.* • *As noted above, capacity utilization*

	has been at current levels in past recessions and has improved in subsequent recoveries.
3. *Lack of pricing power for business will cause sub-par profit growth.*	• *Incredibly strong productivity growth, coupled with declining unit labor costs, are already leading to improving profit margins and profits despite essentially flat volumes in many industries.*
4. *The negative wealth effect will eventually cause consumer spending to roll over.*	• *While equity market losses are, indeed, serious, the decline in stock prices has been offset somewhat by strong real estate appreciation and low interest rates that help to reduce debt service costs.* • *The primary driver of consumer spending remains employment and income which remain satisfactory for this stage of the business cycle.*
5. *The decline in the stock market will require massive pension contributions by employers to defined benefit plans to fund unfunded liabilities.*	• *Increased corporate contributions to pension plans will need to be made over a period of years based upon revised actuarial projections, not in just a year or two.*

Although there always appear to be unique circumstances associated with each economic downturn, the remedies leading to improvement have, over many cycles, been much the same. We believe the recovery ahead will play out favorably because many of these restorative processes are already well under way. The Fed has cut rates eleven times, government spending is stimulative, businesses have taken an axe to their cost structures, corporate and family balance sheets are reliquifying and marginal businesses are failing. Time and again history has shown that these measures pave the way for eventual recovery.

Positive Indicators

In client meetings since late July, we have presented the view that the decline in U.S. shares was in a bottoming process and that prices were likely to move higher later this year and into 2003. Our stock market view is supported by the following observations:

1. A broad cross section of stocks are attractively priced relative to bonds. One method of evaluating the attractiveness of equities relative to bonds is the so-called Fed Valuation Model, which compares the *earnings yield* of the S&P 500 stocks to the yield on U.S. Treasury Bills. This analysis, which is attached for your review, suggests stocks are likely to substantially outperform bonds once a catalyst for improved stock market sentiment emerges. Improved corporate profits or the diminished likelihood of a prolonged war in Iraq would be among the catalysts which could cause such a reversal in sentiment. In fact, the recent stock market rally may be, in part, traceable to better than forecast earnings from market bellwethers IBM, Microsoft, Citigroup and General Electric.

2. Investor sentiment is as depressed today as it was elevated at the market's peak in early 2000. Negative investor sentiment has been a common feature of past major market bottoms. Three examples of the recent general aversion for equities are the $73 billion of net redemptions of equity mutual funds over the last three months, record short interest in NYSE stocks in October, and the unprecedented amount of cash invested in short-term fixed income instruments. Also of interest, is a recent American Association of Individual Investors (AAII) survey indicating that only 29% of respondents thought the market would be higher in six months. This reading stands in sharp contrast to the levels seen at the market's top, when the vast majority of respondents were bullish.

3. The stock markets return for the third quarter was -18%, the thirteenth worst quarter on record. A review of historical returns indicates that in the five times since WWII when a quarterly return was -15% or worse, the market advanced on average by 17% over the next six months, and 22% over the next year.

4. A recovery in corporate profits is underway, but is being masked by write-offs of past activities. As referenced on page 2, operating profits are on track to be up over 30% in the third quarter.

5. Corporate bond yield spreads over Treasury yields are at their widest levels since 1982, a reflection of excessive pessimism in the economic outlook. Simply stated, spikes in credit spreads indicate that economic risks are factored into securities prices. Previous credit spread peaks in 1982, 1988, 1990, 1998, and September 2001 all occurred at bear market bottoms and were precursors to stocks outperforming bonds.

Investment Strategy

As clients are aware, we decided earlier this year to tilt the mix of equity securities in clients' portfolios, which are always balanced between *growth* and *value*, more toward *growth* shares. Although this tactical shift appears to have been premature, this decision gave weight to two key factors which, when present in the past, have invariably led to out-performance by *growth* shares: a positively sloped yield curve and an inflection point in the corporate profits cycle. The rotation we had anticipated away from *value* shares, and small cap value stocks in particular, which had for two and a half years been the top performing category of equities we monitor, has begun to play out, as shown in the table as follows:

	06/30/02-10/23/02	Current Quarter through 10/23/02
Large Cap Growth	-5.3%	+10.7%
Large Cap Core	-9.5	+ 9.9
Large Cap Value	-13.7	+ 9.1
International	-17.0	+ 3.9
Small Cap Growth	-18.8	+ 3.7
Small Cap Value	-21.6	+ 0.2

The return to leadership of large cap growth stocks, which commenced at mid-year and about which we wrote in our August client letter, has contributed to stronger than market performance in equity portfolios under our management during the current quarter.

Within the growth category, we continue to favor three broadly defined groups:

- Depressed high quality technology companies with strong balance sheets and dominant positions in their industries;

- Health Care companies, including drug and medical equipment manufacturers, with good new product prospects able to capitalize on the aging population demographics we forecast;

- Selected retail and media companies well positioned to benefit from increased consumer and advertising spending that always accompanies an upswing in the economy.

On the *value* side, we continue to allocate well over half of this component to financial shares which are particularly undervalued and are expected to recover as credit conditions ease and the visibility of a sustained expansion clarifies. Banking shares, which have suffered because of credit quality concerns, have emerged from the recent recession with stronger balance sheets and higher returns on equity than had been the case following prior business contractions.

As for fixed income portfolio strategy, we continue to view the bond market as quite overvalued. We have, therefore, maintained larger than usual cash equivalent positions and we have allowed the duration of portfolio holdings to drift down to reduce market risk. In the past few weeks, yields on medium and longer-term U.S. Treasury obligations have risen by about 75 basis points (3/4 of a percentage point) and we expect this trend to continue as investors reallocate capital from the bond market to equities. This will ultimately provide a better opportunity to deploy client's funds earmarked for fixed income at still higher yields.

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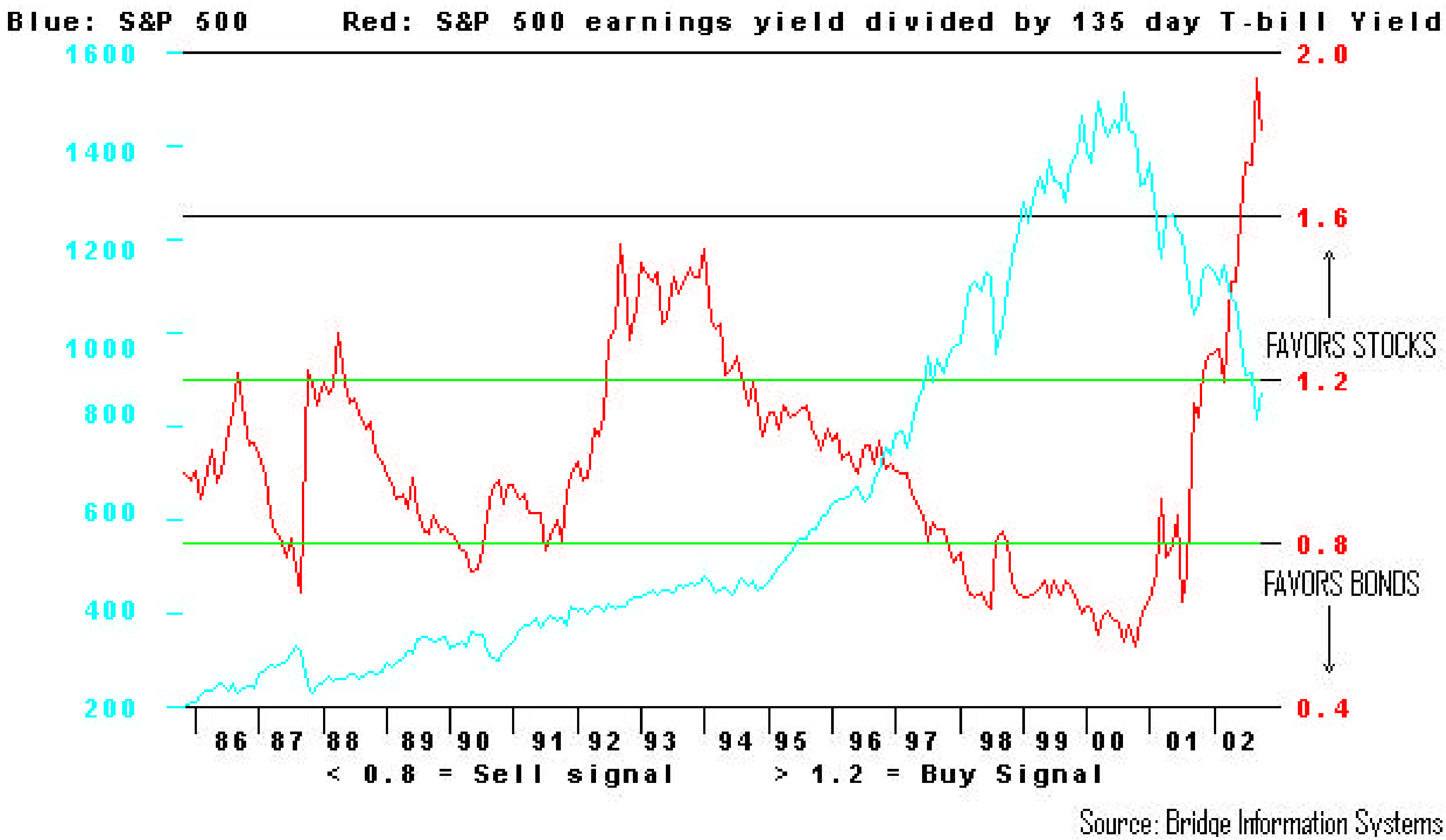
Blue: S&P 500
Red: S&P 500 earnings yield divided by 135 day T-bill Yield
1600
1400
1200
1000
800
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1.6
1.2
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FAVORS STOCKS
FAVORS BONDS
86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02
< 0.8 = Sell signal
> 1.2 = Buy Signal
Source: Bridge Information Systems